

ANALYSIS OF ORIGINAL BILL

Author: Jones Analyst: Nicole Kwon Bill Number: AB 21
Related Bills: See Legislative History Telephone: 845-7800 Introduced Date: December 4, 2006
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Earned Income Refundable Credit

SUMMARY

This bill would allow a refundable Earned Income Credit (EIC) equal to 15% of the federal EIC.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to build on the success of the federal EIC by providing a state credit to low-income taxpayers.

EFFECTIVE/OPERATIVE DATE

As a tax levy this bill would be effective immediately upon enactment, but expressly operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENT

An amendment is suggested to provide appropriation language to fund the departmental costs associated with administering the proposed credit.

ANALYSIS**FEDERAL/STATE LAW**

Existing federal law allows eligible individuals a refundable EIC. A refundable credit allows for the excess of the credit over the taxpayer's tax liability to be refunded to the taxpayer. The credit is a percentage of the taxpayer's earned income and is phased out as income increases. The percentage varies, based on whether the taxpayer has qualifying children.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Selvi Stanislaus

3/8/07

The federal credit for the 2006 taxable year is determined as follows:

Eligible Individual With	Earned Income	Completely Phased-Out @	Credit Rate (%)	Maximum Credit (for all file statuses)
1 qualifying child	\$8,080	\$32,001	34%	\$2,747
2 or more qualifying children	\$11,340	\$36,348	40%	\$4,536
No qualifying children	\$5,380	\$12,120	7.65%	\$412

Married individuals are eligible for only one credit on their combined earned income and must file a joint return to claim the credit.

Existing federal law specifies that if the federal EIC was denied and the Internal Revenue Service (IRS) determined that the taxpayer's error was due to reckless or intentional disregard of the federal EIC rules, the EIC will not be allowed for the next two years. If the error was due to fraud, the EIC will be denied for the next ten years.

Existing federal law allows an eligible individual to receive advance payment of the EIC by providing his or her employer with a Form W-5 (Earned Income Credit Advance Payment Certificate). Taxpayers who receive advance payments of the EIC must still file an income tax return and any advance payments that exceed the allowable EIC are recaptured. While EIC recipients may pay little or no income tax, the advanced EIC payments can be used to pay social security and other payroll taxes.

Under provisions of federal law (Title IV of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193)), certain individuals not lawfully admitted for permanent residence in the United States are ineligible for federal, state, and local public benefits, including the EIC. IRS implementation of Title IV is limited to verifying eligibility on the basis of social security numbers. The IRS delays all returns claiming the federal EIC that do not pass an automated social security number verification process. By its terms, this federal law applies to states that allow EIC.

California does not provide an EIC. Existing state laws provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child and dependent care credits) or to influence business practices and decisions or to achieve social goals. Credits are allowed against net tax based on a set order or priority as specified in the Revenue & Taxation Code.

Under state law, individuals who make less income than the filing thresholds are not required to file an income tax return because the standard deduction and personal exemption credit eliminate any tax liability. For 2006, these filing thresholds are \$13,713 in gross income or \$10,970 in adjusted gross income (AGI) for single taxpayers and \$27,426 in gross income or \$21,940 in AGI for married filing joint taxpayers. These thresholds are increased based on the number of dependents and are increased annually for inflation.

THIS BILL

This bill would provide a refundable state EIC equal to 15% of a previously operative version of the federal EIC (prior to its reduction by alternative minimum tax (AMT)). The amount of state EIC would be reduced by state AMT, if applicable. Any state credit in excess of the state tax liability would be credited against other amounts due, and the balance would be refunded to the taxpayer (subject to legislative appropriation).

This bill specifies the proposed EIC would be refunded to the taxpayer only if funds are appropriated for that purpose by the Legislature.

This bill specifies that no credit shall be allowed to (1) any person who is treated as a nonresident for any portion of the taxable year; or (2) any person who is married and files a separate return for the taxable year.

IMPLEMENTATION CONSIDERATIONS

This bill would require an appropriation of money by the Legislature to pay refunds of this credit. Refunds of the credit to some taxpayers could be delayed if the amount of credits claimed exceeds the funds appropriated. The department has prior experience with the refundable renters' credit where, prior to approval of a continuous appropriation, refunds were delayed and interest had to be paid to taxpayers until more funds were appropriated to cover claims in excess of the initial appropriation. If funds are not available to cover refunds due, this would result in payments of interest to refund recipients and in departmental costs associated with additional calls to the service center inquiring about delayed refunds.

Many taxpayers eligible for the federal EIC have no California income tax return filing requirement. Some 650,000 (married filing joint is counted as one return) current nonfilers would be required to file a California income tax return to claim the proposed EIC, which would significantly impact the department's programs and costs.

Generally, low-income taxpayers would claim the credit proposed under this bill. Low-income taxpayers generally file their tax returns on Forms 540A or 540-2EZ. To add the EIC to the California income tax forms, several lines would be added each to Forms 540, 540A, 540NR, and the scannable Form 540. If there is a need to attach another page to the Form 540-2EZ, the taxpayers currently filing on the Form 540-2EZ would be required to file a Form 540 or a Form 540A to claim the proposed EIC. Changes to these tax forms would result in a significant impact on the department's operations and costs.

Typically, refund returns are filed early in the filing season. If taxpayers claiming the California EIC file late in the filing season, after they receive their federal EIC, that behavior could have a major impact on the processing of returns and possibly cause delays in the issuance of refunds. The taxpayer error rate on the federal EIC and fraud concerns causes the IRS to adjust many returns. Consequently, the correct federal EIC amount may not be known until after the taxpayer has filed the state return, claimed the proposed California credit, and received their refund. The Franchise Tax Board (FTB) could be required to issue an assessment to retrieve incorrect refunds and incur costs to do so.

Under specific provisions of federal law, denial of the EIC is treated as a deficiency, subject to protest and appeal. The bill is silent about whether a claimant would have protest and appeal rights where their claim for the proposed California EIC is denied by the department.

Relying on the EIC under federal law may present implementation problems for Registered Domestic Partners (RDPs). RDPs are required to file California income tax returns using the rules applicable to married individuals. If the author's intention is to allow EIC for RDPs, a rule should be included in the bill to address the difference between federal and state law. Department staff is available to work with the author's office to resolve the implementation concerns.

TECHNICAL CONSIDERATIONS

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-16) made several changes to the federal EIC, such as redefining earned income, simplifying the calculation of the EIC by using AGI, and eliminating the reduction of EIC for taxpayers subject to AMT. Even though this bill refers to the EIC, as amended by EGTRRA, the federal EIC has been amended by four public laws since enactment of EGTRRA. The author's office may not want to apply a provision of federal law that is no longer applicable for federal purposes. Accordingly, it is recommended that "as amended by Public Law 106-107" on page 2, lines 21 and 22, should be deleted.

The provision in the bill related to Internal Revenue Code Section 3507 is unnecessary because this section is not applicable for California purposes. Accordingly, it is recommended that page 2, lines 18 to 19 should be deleted.

LEGISLATIVE HISTORY

SB 224 (Cedillo, 2003/2004) was similar to this bill in regard to providing a refundable EIC equal to 15% of the federal EIC. SB 224 did not pass out of the Senate Revenue & Taxation Committee.

AB 1854 (Cedillo, 1999/2000) and SB 1421 (Solis, 1999/2000) were similar to this bill. AB 1854 did not pass out of the Assembly Appropriations Committee. SB 1421 did not pass out of the Senate Revenue & Taxation Committee.

AB 2466 (Wiggins, 1999/2000) would have provided a nonrefundable EIC in an amount equal to an unspecified percentage of the earned income credit allowed by federal law. This bill did not pass out of the Assembly Revenue & Taxation Committee.

PROGRAM BACKGROUND

Prior to its sunset in 1992, California law provided a nonrefundable low-income tax credit in an amount ranging from 20% to 100% of the "computational tax," as defined, based on the taxpayer's AGI. The AGI amounts were indexed annually by the FTB. The "computational tax" was defined as the regular tax less all nonrefundable tax credits. This low-income tax credit could only be taken after all other allowable credits, except refundable credits.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida has no personal income tax, thus a refundable credit against tax is not applicable.

Illinois allows taxpayers to claim a nonrefundable credit equal to 5% of their federal EIC on their return.

Massachusetts allows taxpayers to claim a refundable credit equal to 15% of their federal EIC. If the taxpayer has requested the IRS to calculate the federal EIC and the IRS has not notified the taxpayer by April 15th of the amount of the federal credit, Massachusetts allows the taxpayer a six-month extension to file the Massachusetts income tax return.

Michigan allows taxpayers to claim a refundable credit equal to 10% of their federal EIC for tax years that begin after December 31, 2007, and before January 1, 2009. The credit is 20% of the federal EIC for tax years that begin after December 31, 2008.

Minnesota allows taxpayers to claim a Working Family Credit (WFC) if they also claimed the federal EIC. The WFC is based on either the federal earned income or federal AGI, depending on whichever amount is smaller.

New York allows taxpayers to claim a refundable credit equal to 30% of the federal EIC on their return for tax years beginning in 2003 and before January 1, 2008.

FISCAL IMPACT

The department anticipates first year implementation costs of approximately \$5 million for fiscal year 2007-08 if this bill is effective January 1, 2008. This estimate may be revised as implementation concerns are resolved, and the bill moves through the legislative process. Amendment 1 is provided to suggest language for an appropriation to fund these departmental costs.

The costs to implement the provisions of this bill include printing and processing returns for an estimated 650,000 new filers who currently do not have a filing requirement, but would file solely to claim the refundable EIC. Additional activities contributing to costs include making changes to tax forms and instructions, programming changes to computer systems, handling increased taxpayer phone calls and correspondence, storing additional electronic and paper returns, and investigating fraud cases related to EIC.

The department anticipates ongoing annual costs of approximately \$4.3 million beginning with the 2008/2009 fiscal year to continue activities described above, which the department would pursue in the course of the normal budget process.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 21 As Introduced December 4, 2006 Effective for tax years BOA 1/1/2008 Enacted after 6/30/2007 (\$ in Millions)		
2008-09	2009-10	2010-11
\$-710	\$-720	\$-730

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of this credit would depend on the number of California taxpayers claiming the federal EIC. This amount, in turn, depends on the amount of earned income and AGI claimed by low-income Californians and whether they currently file a tax return. It is assumed that almost all taxpayers who avail themselves of the federal credit will also avail themselves of the state credit. There is a significant number of taxpayers who are eligible for but do not avail themselves of the federal EIC. It is assumed that the availability of a California EIC would not entice a significant number of taxpayers who already fail to claim the federal EIC to begin claiming the California EIC.

The starting point for this estimate is the amount of federal EIC claimed by California residents in the 2004 tax year, which is approximately \$4.5 billion. This number is then adjusted from the 2004 level to the 2011 level by overall return growth projections.

The amount of the federal EIC for 2008 is estimated to be \$4.7 billion. For each tax year, the estimated federal EIC amount is multiplied by 15%, the proposed state credit rate, to arrive at the total state impact for that year. The estimated revenue impact for 2008 is \$710 million (\$4.7 billion x 15%).

LEGAL IMPACT

This bill contains provisions that would target certain incentives to residents of California while denying the same incentive to nonresidents. The U.S. Supreme Court in *Lunding Et Ux. v. New York Appeals Tribunal et al.* (1998) 118 S. Ct. 766, found that denying a tax benefit to a nonresident taxpayer, while allowing such a benefit to resident taxpayers, was discriminatory and thus unconstitutional. Consequently, an EIC conditioned on residency in California may be subject to constitutional challenge.

POLICY CONCERNS

The IRS has experienced a significant number of invalid and fraudulent returns in connection with the refundable federal EIC. According to a study conducted by the IRS entitled "Compliance Estimates for the Earned Income Credit Claimed on 1999 Returns," of the \$31.3 billion claimed in federal EIC, it is estimated that between \$8.5 and \$9.9 billion were invalid or fraudulent claims.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 21
As Introduced December 4, 2007

AMENDMENT 1

On page 2, after line 33, insert:

SEC. 2. The sum of five million dollars (\$5,000,000) is hereby appropriated to the Franchise Tax Board in augmentation of its support budget (item of the Governor Budget- Chap __, Statutes of_____).

SEC. 3